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REPORT
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FHA MODERNIZATION ACT OF 2007

NOVEMBER 13, 2007.—Ordered to be printed

Mr. DODD, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany S. 2338]

The Committee on Banking, Housing, and Urban Affairs, having had under consideration an original bill (S. 2338) to modernize and update the National Housing Act and enable the Federal Housing Administration to more effectively reach underserved borrowers, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

INTRODUCTION

On September 19, 2007, the Committee on Banking, Housing, and Urban Affairs considered a Committee Print, entitled the "FHA Modernization Act of 2007," a bill to modernize and update the Federal Housing Administration program. The Committee voted 20 to 1 to report the bill.

PURPOSE AND SUMMARY OF THE LEGISLATION

The "FHA Modernization Act of 2007" updates the Federal Housing Administration's single-family insurance program to enable the program to serve more home buyers and borrowers, and to serve them more effectively. This reform is particularly important, as President Bush has said, in light of the current mortgage crisis that has driven foreclosure rates to historic levels. The legislation is the result of close consultations of Committee staff, staff of Com-

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mittee Members, and the Department of Housing and Urban Development (HUD).

The Act extends the benefits of FHA insurance to a larger number of families by raising loan limits and simplifying downpayment requirements. It also makes FHA insurance more accessible to people buying or refinancing condominiums and cooperatives, including manufactured housing condominium and cooperative developments. The legislation streamlines the FHA authorizing statute by moving all single-family programs into a single fund within FHA. The legislation also expands access to post-purchase homeownership counseling to help people keep their homes and avoid foreclosure; it also establishes a demonstration to determine the most effective form of pre-purchase counseling for first-time home buyers.

While much of the legislation focuses on the single-family mortgage insurance program set out in Title II of the National Housing Act, the legislation also modernizes and expands the Title I program dealing with manufactured housing. It also removes the current cap on the number of so-called "reverse mortgages" made through the Home Equity Conversion Mortgage (HECM) program and raises the loan limit for this program to a single national loan limit. The HECM program has been a demonstration program; this legislation makes the HECM program a permanent feature of FHA.

BACKGROUND AND NEED FOR THE LEGISLATION

Prior to the creation of FHA in 1934, homeownership rates in the United States in the early decades of the 20th century were about 45 percent and the mortgage market was much different than the market with which we are familiar today. Home buyers could only borrow 50 percent of the value of the home; and they had to fund the other 50 percent through savings or other means. Banks made exclusively interest-only mortgage loans for periods of 3 to 5 years, after which the principle of the loans was due in full. At that point, borrowers would have to refinance their mortgages on whatever terms were available, starting the cycle over again. During the Great Depression, however, as the banking system started failing, lenders were unwilling or unable to refinance many of the loans that came due, forcing many homeowners to pay off their loans in full, which they were simply unable to do. Other borrowers who had lost their jobs no longer could have qualified for mortgages, even if funds had been available. As a result, many homeowners ended up defaulting on their loans and losing their homes to foreclosure, driving property values and home prices downward.

It was in the midst of this crisis that FHA was created by the Congress. FHA encouraged the private sector to return to the mortgage market during this period by offering government-backed insurance for the full balance of the loan. This same benefit continues to operate today. While large segments of our mortgage markets have been struck by a significant contraction, the FHA-insured market continues to operate smoothly, and, in fact, attract additional business. When it was first created, FHA not only got banks lending again, it also standardized mortgage instruments and underwriting procedures.[1]

FHA fundamentally restructured the mortgage market, turning it into the market we recognize today. FHA institutionalized a "revolutionary idea"[2]—fully amortizing mortgages with 20-year terms requiring only 20 percent downpayments. Over time, terms were extended out to the current traditional 30 years, and downpayments were greatly reduced. These long-term, low downpayment loans brought homeownership well within the means of millions of additional American families.

FHA—Current Market Conditions—Traditionally, FHA has played a major and disproportionately large role in providing home purchase financing to minority, first-time, and lower-income home buyers.[3] However, from 1996 to 2005, the FHA saw its overall market share drop dramatically, as well as its share of the minority and low-income markets. The GAO reports that during that time, FHA's market share fell 13 percentage points (from 19% to about 6%). At the same time, the subprime market share grew 13 percentage points (from 2% to 15%). The prime market share rose slightly (about 5 percentage points) during this period.

In addition, FHA experienced a "*sharp decrease among minority and lower-income populations* where it traditionally has had a strong presence."[4] Among minority borrowers, for example, FHA's share of the market dropped 25 percentage points (from 32% to 7%) at the same time that the subprime market share increased by 24 percentage points (from 2% to 26%) among that population.

For lower-income borrowers (defined as less than 80% of area median income), the story is much the same. FHA share fell 16 percentage points while the subprime share went up 14 percentage points over the same period of time. For both minority and lower-income borrowers, the prime market share rose modestly (6 and 7 percentage points respectively).

These data strongly indicate that much of the gain in subprime market share has been at the expense of FHA. This, in turn, has raised concerns both at HUD and among members of the Committee that these borrowers are not getting the most suitable, lowest-cost loans for which they qualify. Driving this shift is the fact that the dominant subprime product in recent years has been the 2/28 hybrid adjustable rate mortgage (ARM), which offers a lower initial teaser interest rate, or an interest-only feature and, in many cases, requires little or no down-payment. Most of the time, these loans do not include escrow accounts for taxes or insurance, allowing mortgage originators to make it appear that the monthly payments are cheaper than alternatives such as FHA alternatives that are safer and more affordable in the long-term. As the GAO report points out, while they appear to be cheaper at first, "these mortgages became more costly as the interest rates on many of these

[1] Albert Monroe, "How the Federal Housing Administration Affects Homeownership," Harvard University paper, November, 2001.
[2] Bruce Foote, FHA Loan Insurance Program: An Overview, CRS, July 31, 2007.
[3] GAO, Federal Housing Administration: Decline in the Agency's Market Share Was Associated with Product and Process Developments in Other Mortgage Market Participants, June, 2007 (GAO–07–645). In 2005, 53.1 percent of FHA loans went to low-income buyers, and 29.3 percent went to minorities. Page 42.
[4] GAO briefing materials provided to Members' staff, July 13, 2007. Emphasis in the original.

loans reset to higher rates, typically 2 to 3 percentage points higher in a relatively short time period."[5]

In addition to offering teaser rates, subprime originators, who are overwhelmingly mortgage brokers, have provided faster approval times than FHA. In part, this reflects a problem with the administration of FHA, and in part, it reflects questionable and unscrupulous sales practices used by some mortgage brokers and lenders in the subprime market. In hearings held on February 7 and March 22, 2007, it was shown that mortgage brokers often represent themselves as "mentors,"[6] or trusted advisors, to borrowers while simultaneously claiming to be independent third parties without a duty to the borrower. Brokers and some loan officers get additional compensation for steering borrowers to higher cost loans. This has created incentives for originators to direct borrowers away from the generally safe and affordable FHA loans toward more-expensive, higher-rate subprime loans.

An oft-mentioned goal of HUD and members of the Committee for the FHA modernization legislation is to make FHA a more viable alternative to the subprime market, especially for those borrowers who the program has traditionally served because of the more consumer-friendly terms of FHA loans. Indeed, Home Mortgage Disclosure Act (HMDA) data show that, while FHA borrowers have, on average, credit scores that are very similar to subprime borrowers' scores, and significantly lower than scores for prime borrowers, FHA borrowers pay interest rates that are nearly identical to prime borrowers and considerably lower than rates paid by subprime borrowers. Moreover, two-thirds of subprime borrowers have prepayment penalties, which are prohibited for FHA loans. Finally, fewer than 10% of FHA loans are ARMs, whereas nearly 73% of subprime loans in 2005 were ARMS.[7]

Overall, FHA delinquency rates have been similar to those in the subprime market. However, MBA's most recent data (National Delinquency Survey) shows total past due loans (at least 30 days) to be higher for subprime loans than for FHA loans over the past two quarters, though some prior quarters have had contrary results. Nonetheless, new foreclosure rates for FHA loans are and have long been sharply lower than those for subprime loans, in large part because FHA has an effective loss mitigation program which is particularly good in its use of tools that help homeowners retain their homes. For example, the rate of FHA-insured mortgages going into foreclosure in the second quarter of 2007 was 0.79 percent of the total FHA portfolio compared to 2.72 percent for subprime loans.

Administrative Improvements—FHA has undertaken a number of administrative efforts to make its programs easier to use by originators. For example, FHA introduced the Lender Assistance Program, which allows higher-performing lenders to endorse FHA loans without prior review of the paperwork by HUD. Before this change, instituted in January, 2006, all lenders were required to send each loan binder to the Department for review, a costly and

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[5] GAO–07–645, page 24.

[6] FAQ section of the official web site of the National Association of Mortgage Brokers (www.NAMB.org). After the hearing in which this was pointed out to the President of NAMB, the reference to "mentors" was removed.

[7] GAO–07–645, Appendix III, pages 42–44.

very time-consuming process that often resulted in lenders choosing other alternatives . While not doing up-front reviews, FHA continues to do post-endorsement audits of the lenders. In addition, FHA has streamlined its appraisal and closing cost protocols as well, "to align them more closely with conventional standards." [8]

According to lenders and industry groups, these changes have significantly reduced processing times for FHA loans (by about 35%), reduced the costs of its FHA business (by about 25%), and shortened the time it takes to close an FHA loan, an important consideration in a competitive market. In addition, the Lender Insurance Program has saved FHA more than $2 million in contracting costs and $70,000 in mailing costs in the first 9 months of the program.[9]

The Committee expects that these administrative improvements, taken together with the legislative changes contained in this Act, will make it more likely that lenders will, once again, include FHA in the choice of products they offer to consumers.

Financial Condition—FHA is in a very strong financial position; it has a record $22 billion in capital, and a capital ratio of 6.82 percent,[10] more than 3 times its statutory minimum of 2 percent. Like the market as a whole, recent FHA loan performance has not been as strong as expected. According to the President's FY 2007 budget submission, without certain reforms, many of which are contained in this legislation, HUD might be required to raise upfront premiums from 1.50 percent to 1.66 percent in order to avoid the need to seek appropriated credit subsidy for the FY 2008 book of business. However, HUD recently finalized a rule prohibiting the use of seller-financed downpayment assistance entities in conjunction with FHA insurance. These programs have been responsible for a significant and disproportionate amount of FHA single-family losses. As a result of this new regulation, FHA will be able to cover its expected losses for its FY 2008 book of business without any appropriated credit subsidy. It should be pointed out that the proposed legislation does allow for lower downpayments, which is an important risk factor. On the other hand, the independent actuarial review of FHA notes that higher balance loans perform better. Since this legislation raises the FHA loan limits, this should mitigate some of the risk created by allowing lower downpayments. In either case, the Committee expects the Department to continue to monitor the performance of the FHA fund very closely.

SECTION BY SECTION

Title I—Building American Homeownership Act

Section 101—Short title

Establishes the title as the "Building American Homeownership Act of 2007."

Section 102—Maximum principal loan balance

Increases FHA Section 302(b)(2) single-family mortgage loan limits. Under current law, the maximum insurable mortgage loan

[8] GAO–07–708, page 13.
[9] GAO–07–708, page 14.
[10] An Actuarial Review of the FHA Mutual Mortgage Insurance Fund for Fiscal Year 2006, Technical Analytics Center, Inc. This is the independent actuarial study of the FHA fund.

amount for a single-family residence is the lesser of (a) 95 percent of the local median home price, or (b) 87 percent of the nationwide government-sponsored entity (GSE) conforming loan limit—except that notwithstanding the local median home price, there is a national loan floor equal to 48 percent of the nationwide GSE conforming limit. This section raises the loan limit to the lesser of: (a) 100 percent of the local median home price, or (b) the nationwide GSE conforming loan limit. It also raises the nationwide loan floor from 48 percent to 65 percent of the GSE conforming limit. In 2007, the nationwide GSE conforming loan limit is $417,000.

This section also changes the calculation for 2-, 3-, and 4-unit mortgages so that the ratio of loan limits for 2-, 3-, and 4-unit mortgages to the FHA 1-unit mortgage limit is conformed to the same ratio used to calculate the GSE limits for homes with the same number of units. The maximum loan amount for any particular property would be 100 percent of the appraised value of the property.

There are numerous markets around the country where home prices have skyrocketed to the point where FHA has been effectively eliminated from the market. The Committee expects that raising the loan limits will make FHA-insured mortgages available to more people.

Section 103—Cash investment requirement and prohibition of seller-funded downpayment assistance

Current law includes a complex calculation that generally allows a 3-percent minimum cash investment or downpayment, though that amount varies by loan amount and for states with high closing costs. Mortgage insurance premiums and closing costs may be financed into the loan. This section simplifies the calculation to require a minimum 1.5-percent cash investment of the appraised value of the property for all FHA-insured loans. As in current law, family members may contribute to this amount.

Lenders cite the complexities of the calculation of the minimum investment requirement, commonly known as the downpayment, as one of the reasons that they do not use FHA more frequently. This section simplifies that calculation and reduces it, making it a flat 1.5 percent of the appraised value of the property. However, the Committee-passed bill does not allow for a zero downpayment, as requested by the Administration, although closing costs, FHA premiums, or other fees may be financed up to 100 percent of the value of the home. The legislation reflects the views of the members of the Committee that a borrower should be required to make a real investment in the purchase of his or her home.

This section also prohibits seller-funded downpayment entities from providing any of this required cash investment. Since this legislation was passed by the Committee, HUD has promulgated a regulation that also prohibits these entities from providing downpayment assistance funds. Both the HUD Inspector General and the GAO have found that loans originated in conjunction with these funds have led to significant losses for the FHA fund. Moreover, the Internal Revenue Service has found that these organizations, while calling themselves non-profit charities, have not always acted in the interest of the homebuyer. According to the IRS:

> Increasingly, the IRS has found that organizations claiming to be charities are being used to funnel down payment assistance from sellers to buyers through self-serving, circular-financing arrangements. In a typical scheme, there is a direct correlation between the amount of the down payment assistance provided to the buyer and the payment received from the seller. Moreover, the seller pays the organization only if the sale closes, and the organization usually charges an additional fee for its services. Such programs have non-charitable purposes of facilitating real estate sales for the benefit of sellers and related financing entities. Thus the organizations do not meet the requirement of section 501(c)(3) that they be operated exclusively for charitable purposes.[11]

Section 104—Mortgage insurance premiums

Currently, the maximum up-front mortgage insurance premium is 2.25 percent of the insured principal balance of the loan. This section would allow FHA to charge up to 3.0 percent. Current law limits the up-front premium to 2.0 percent for first-time homebuyers who complete approved homeownership counseling. The Committee bill retains this 25 basis point discount, thereby lowering the maximum premium for borrowers who receive counseling to 2.75 percent.

Section 105—Rehabilitation loans

This section deletes obsolete language in existing Section 203(k) rehabilitation loans and moves the program from the General Insurance Fund to the Mutual Mortgage Insurance Fund within FHA.

Section 106—Discretionary action

Moves existing language contained in Section 203(s) of the National Housing Act dealing with notification requirements about actions taken by the Secretary to suspend or revoke the approval of a mortgagee to participate in FHA programs to Section 202 of the National Housing Act, which contains the basic authority of the Mortgagee Review Board, the Board that does lender reviews.

Section 107—Insurance of condominiums and manufactured housing

Amends Section 201(a) of the National Housing Act to add a definition of condominium mortgage to the definition section, consistent with the intent to insure condominium mortgages under Section 203 of the Act, and to provide that condominiums may be in the form of manufactured housing units. Modifies the definition of real estate to permit manufactured homes to be financed, even though they are not taxed as real property.

Section 108—Mutual Mortgage Insurance Fund (MMIF)

Clarifies that the MMIF is subject to the provisions of the Credit Reform Act of 1990. Directs HUD to ensure that the MMIF remains financially sound. Also requires HUD to provide an inde-

[11] Internal Revenue Service, July 2007.

pendent actuarial report to Congress annually on the financial status of the Fund, and requires HUD to submit a quarterly report on the financial status and soundness of the Fund. Grants HUD the authority to change underwriting standards or premiums if the Fund is at risk.

Makes insured mortgages that are used in conjunction with the Homeownership Voucher program the obligation of the MMIF, and makes reverse mortgages under Section 255 of the National Housing Act obligations of the MMIF.

Section 109—Hawaiian Home Lands and Indian Reservations

Makes single-family mortgages insured on Hawaiian Home Lands under Section 247 of the National Housing Act and single-family mortgages insured on Indian Reservations under section 248 of the Act obligations of the MMIF.

Section 110—Conforming and technical amendments

Repeals certain obsolete or little-used programs, and makes other technical and conforming amendments.

Section 111—Insurance of mortgage

Allows FHA insurance to be used more effectively in cooperatives.

Section 112—Home Equity Conversion Mortgages (HECMs)

Eliminates the current cap on the number of HECMs FHA may insure. Provides for a uniform nationwide mortgage loan limit on FHA reverse mortgage loans equal to the GSE conforming loan limit. Limits the origination fee on such mortgages to 1.5 percent (down from the current 2 percent) subject to a minimum allowable amount. Permits FHA reverse mortgage loans to be used in cooperatives, and authorizes reverse mortgages to be taken out on newly purchased homes as long as the home is the primary residence of the mortgagor. Gives the FHA Commissioner the authority to increase or lower the fee cap, depending on market conditions.

The HECM program was originally authorized in 1987 as a demonstration program, with a cap on the total number of such mortgages FHA would be allowed to insure. The cap has been raised a number of times since then. In recent years, the program has grown faster as more elderly households have turned to HECMs as a safe and effective way to tap their home equity without incurring monthly payments and without risking default or foreclosure. As a result, FHA has reached the program cap numerous times, resulting in either the program being shut down or requiring Congress to act quickly to raise the cap. The Committee believes that the HECM program has proved to be a success, so this legislation eliminates the cap.

As noted, the Committee also establishes a single national loan limit for HECMs. This limit will allow seniors to safely withdraw more equity from their homes. The Committee chose to tie this new higher limit to a provision lowering origination fees. Without the lower fee, many seniors would have to pay higher origination fees for loans of the same size because the fee is calculated on the basis of the maximum allowable loan rather than on the actual size of the loan. The Committee believes that the lower origination fee will make HECMs more accessible to a wider range of seniors. However, the legislation also gives the Secretary of HUD considerable authority to raise this fee if he or she believes it is constraining the willingness of lenders to participate in the reverse mortgage market on the one hand, or lower the fee if he or she concludes that additional savings for consumers would be forthcoming without restricting credit on the other hand.

The Committee expects that removing the cap and establishing a new, higher, and uniform loan limit will encourage new competitors to enter the reverse mortgage market, as both the National Association of Reverse Mortgage Lenders (NRMLAs) and AARP contend. Such increased competition should help further to control fees.

Section 113—Energy efficient mortgages

Current law includes an energy efficient mortgages pilot program. This section raises the cap on the value of the energy efficiency improvements from a maximum of 5 percent of the value of the property up to $8,000, to the greater of 5 percent of the single-family loan limit established under Section 203(b)(2)(A) or 2 percent of the limit established under Section 203(b)(2)(B). The pilot is also capped at no more than 5 percent of the number of loans originated under the single-family program in the preceding year.

The Committee recognizes that residential structures contribute significantly to greenhouse gases. The Committee hopes that this program will help encourage the use of FHA to finance energy-efficient homes and energy efficiency improvements. The Committee urges HUD to look at other ways to achieve this goal by encouraging the broader housing finance market to take into account energy savings generated by energy-efficient design, materials, appliances, and the like, as well locations of homes to public transportation, when calculating what a potential home buyer may be able to afford for a home.

Section 114—Pilot program for automated process for borrowers without sufficient credit history

This section requires HUD to carry out a pilot program to establish an automated process for providing alternative credit rating information for borrowers who have insufficient credit histories for determining their creditworthiness. Under this section, HUD is limited to insuring no more than 5 percent of the aggregate number of FHA-insured mortgages in the preceding year originated with this alternative scoring process. The section requires the GAO to study the impact of the pilot, which sunsets 5 years after the bill's enactment.

It is widely acknowledged that certain borrowers with "thin" credit files have lower credit scores and may pay more for mortgages and other credit than a more accurate analysis of their risk would require. Some experts point to the fact that these borrowers may have a strong history of on-time payments for items that are often not included in certain credit scores, such as rent and utilities. The Committee believes that using FHA to test a number of different methods for measuring this risk more accurately, under controlled circumstances, is a worthwhile goal for a government-run program. The Committee hopes that this pilot program will develop a system that can be more widely used, both by FHA and other lenders.

Section 115—Homeownership preservation

Requires the Secretary of HUD and FHA Commissioner, in consultation with the industry and other experienced parties, to develop and implement a plan to improve FHA's loss mitigation process. FHA's loss mitigation program is already an effective tool for preventing foreclosures. However, data from HUD show that there is still a significant number of FHA borrowers who are never contacted, never offered the opportunity to engage in loss mitigation, or who run into other problems and end up in foreclosure. The Committee expects HUD to work with industry groups and consumer and community groups, many of which are successfully partnering with servicers today to work with delinquent borrowers, in an effort to help people save their homes, to cut down on the number of FHA borrowers who go through foreclosure or are required to give up their homes through short sales and the like.

Specifically, the Committee expects the Department to work with these groups to make earlier contact with delinquent borrowers by third parties with foreclosure prevention counseling experience easier and more routine. In addition, the Committee expects the Department to explore how counseling groups may be able to be paid on a fee-for-service basis, possibly from the FHA fund, to help ensure the development and retention of skilled counselors. Finally, the Committee urges the Department to require servicers to provide counselors and the public with a dedicated telephone number for loss mitigation experts, so that they can reach the appropriate servicing staff as quickly and easily as possible. The Committee believes that all these steps will help improve home retention numbers for delinquent FHA borrowers, and decrease the losses experienced by the Fund.

Section 116—Use of FHA savings for improvements in FHA technologies, procedures, processes, program performance, staffing, and salaries

Authorizes $25 million from any negative subsidy generated by the FHA title II program to be appropriated to modernize the technology, staffing, and other processes of FHA. Prior to such an appropriation, the Secretary of HUD must certify that the FHA Mutual Mortgage Insurance Fund (MMI Fund) met its required capital ratio, and that other FHA insurance funds are in a safe and sound condition.

Section 117—Post-purchase housing counseling eligibility improvements

Expands the eligibility for post-purchase housing counseling by a HUD-approved housing counseling entity to families that suffer significant drops in income, or significant increases in basic living expenses due to medical expenses, divorce, and other factors. The Committee expects that this provision will make many more families experiencing hardships eligible for counseling that may help them save their homes.

Section 118—Pre-purchase homeownership counseling demonstration

Creates a new, pre-purchase homeownership Counseling Demonstration designed to test, in a scientifically valid way, the effectiveness of a variety of types of pre-purchase counseling for first time homebuyers with low downpayments. The Committee believes that such a demonstration will be useful in identifying what types of pre-purchase counseling are most effective in helping lower downpayment borrowers prepare for and achieve sustainable homeownership. The Committee expects HUD to work with Congress to determine how best to implement this section.

Section 119—Fraud prevention

Ensures that any fraudulent activity against FHA is punished in an equivalent way to fraud against other federal entities, or federally-insured or chartered financial entities.

Section 120—Limitation on mortgage insurance premium increases

Prohibits HUD from increasing premiums for the FHA multifamily insurance program above the FY2006 premiums except to cover increases in expected losses. This prohibition stays in effect until October 1, 2009.

Section 121—Savings provision

Provides that any mortgage insured before the bill's date of enactment shall continue to be governed by laws, regulations, orders, and terms and conditions that existed prior to the bill's enactment.

Section 122—Implementation

Requires HUD to establish by notice any additional requirements necessary to carry out the provisions of this bill, which shall take immediate effect.

Title II—Manufactured Housing Loan Modernization

Section 201—Short title

Establishes the title as the "FHA Manufactured Housing Loan Modernization Act of 2007."

Section 202—Purposes

Contains the findings and purposes, including that manufactured housing is an important source of homeownership and that the current FHA title I program structure has inhibited its use and should be reformed.

The Committee expects that the FHA title I manufactured housing program will be an effective tool in helping more people to afford homeownership. This title is intended to help achieve that result by making the program operate more like the traditional FHA single family mortgage insurance program, while taking into account the differences in the ownership structure of the housing.

Section 203—Exception to limitation on financial institution portfolio

Changes from a lender portfolio system to a loan-by-loan insurance system, as in Title II. Retains the 10% lender co-insurance.

Section 204—Insurance benefits

Requires FHA to pay claims on a loan-by-loan basis, absent fraud or misrepresentation.

Section 205—Maximum loan limits

Increases the Title I program loan limits, which have not been adjusted since 1992. The limit for the manufactured housing repair program increases from $17,500 to $25,090. The limit for the home-only program, the primary Title I program, increases from $48,600 to $69,678. The limit for the land and home program increases from $64,800 to $92,904. The limit for the lot-only program increases from $16,200 to $23,226. Provides for inflation adjustments based on an index to be established by the Secretary based on manufactured housing price data.

Section 206—Insurance premiums

Increases the maximum upfront premium from 1% to 2.25%. Sets the maximum annual premium at 1% rather than a sliding scale based on loan term. Requires that FHA charge sufficient premiums such that the Title I program maintains a negative credit subsidy.

Section 207—Technical corrections

Technical corrections, including authority for the Secretary to dispose of property.

Section 208—Revision of underwriting criteria

Requires that within 6 months of enactment, HUD reform the Title I loan underwriting standards to ensure that the program is financially sound.

Section 209—Prohibition against kickbacks and unearned fees

This section applies certain provisions of the Real Estate Settlement Procedures Act (RESPA) to the purchase of manufactured homes financed with FHA-insured loans. The section also gives the Secretary of HUD broad authority to determine how to reasonably apply this section, and to make exemptions as necessary. Finally, the section gives the Secretary the authority to prohibit unfair or deceptive practices in connection with the purchase of manufactured homes with a loan insured under this title.

The Committee is concerned that, while this title will expand the availability of FHA-insured manufactured housing financing, there have been many abuses over the years in the financing of manufactured housing. The Committee expects the Secretary to ensure that RESPA rules against kickbacks and fees, gifts, or other benefits paid or given for the referral of business are strictly enforced when FHA is used to finance the purchase of manufactured homes. The Committee also expects the Secretary to exercise his authority under this section to ensure that consumers are treated fairly.

Section 210—Leasehold requirements

This section requires that manufactured homes that are financed with FHA insurance be placed in manufactured home communities only if that community provides a lease with a minimum term of 3 years that is renewable for successive 1 year terms. In addition, the section requires that the lessee of the home be provided with a notice of at least 180 days prior to the closing of the manufactured home community.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

FHA Modernization Act of 2007

Summary: This legislation would amend the National Housing Act to provide the Federal Housing Administration (FHA) with new authorities aimed at expanding FHA's share of the market for mortgage insurance. This legislation also would permanently remove the statutory limitation on the number of reverse mortgages that FHA can insure and would make other changes to the Home Equity Conversion Mortgage (HECM) program. In addition, this legislation would authorize the appropriation of funds to support various improvements to FHA's administrative functions and would modify FHA's loan guarantee program for manufactured housing.

CBO estimates that implementing this legislation would result in a net cost of $22 million in 2008 and a net increase in offsetting collections (a credit against discretionary spending) of $1.6 billion over the 2008–2012 period, assuming that appropriation laws necessary to implement the FHA programs and the Mortgage-Backed Securities (MBS) program of the Government National Mortgage Association (GNMA) are enacted.

Enacting this legislation could affect direct spending and revenues because the bill would impose criminal penalties for certain fraudulent acts committed against FHA. Criminal fines are recorded as revenues, then deposited in the Crime Victims Fund, and later spent (as direct spending). CBO estimates that any increase in criminal penalties would not be significant.

The legislation contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impost no costs on state, local, or tribal governments.

Estimated cost to the Federal Government: The estimated budgetary impact of the bill is shown in the following table. The cost of this legislation falls within budget function 370 (mortgage and housing credit). For this estimate, CBO assumes that this legislation will be enacted near the start of fiscal year 2008, that the amounts necessary to implement the bill will be appropriated for each year, and that appropriation laws necessary to implement the FHA and GNMA programs will be enacted each year.

Basis of estimate: CBO estimates that implementing this legislation would result in a net increase in offsetting collections of $1.6 billion over the 2008–2012 period, assuming enactment of appropriation laws necessary to implement the FHA and GNMA programs. Those estimated offsetting collections would mostly stem from the authority in the legislation to expand FHA's HECM loan program. Other offsetting collections for GNMA would result from the change to the loan limits for FHA's single-family program. Additional discretionary costs associated with limiting a planned increase in mortgage insurance fees and authorizing the appropriation of funds to support various improvements to FHA's administrative functions would increase costs subject to appropriation.

CBO expects that other provisions of the bill would have no significant budgetary impact over the next five years. The major provisions of the bill are discussed below.

	By fiscal year, in millions of dollars—				
	2008	2009	2010	2011	2012
SPENDING SUBJECT TO APPROPRIATION					
Net FHA and GNMA Spending Under Current Law: [1]					
Estimated Authorization Level	−913	−425	−425	−425	−425
Estimated Outlays	−913	−425	−425	−425	−425
Proposed Changes:					
Amendments to HECM Loan Program:					
Estimated Authorization Level	−10	−385	−410	−445	−480
Estimated Outlays	−10	−385	−410	−445	−480
Additional GNMA Offsetting Collections:					
HECM Provisions:					
Estimated Authorization Level	*	−6	−6	−10	−15
Estimated Outlays	*	−6	−6	−10	−15
Raising Loan Limit for the Single-Family Program:					
Estimated Authorization Level	−7	−8	−9	−10	−11
Estimated Outlays	−7	−8	−9	−10	−11
Limit on Premium Increases for Mortgage Insurance:					
Estimated Authorization Level	20	43	0	0	0
Estimated Outlays	20	43	0	0	0
Improving FHA Administrative Functions:					
Estimated Authorization Level	25	25	25	25	25
Estimated Outlays	19	25	25	25	25
Amendments to Manufactured Housing Loan Guarantee Program:					
Estimated Authorization Level	0	*	*	*	*
Estimated Outlays	0	*	*	*	*
Total Changes:					
Estimated Authorization Level	28	−331	−400	−440	−481
Estimated Outlays	22	−331	−400	−440	−481
Net FHA and GNMA Spending Under Legislation:					
Estimated Authorization Level	−885	−756	−825	−865	−906
Estimated Outlays	−891	−756	−825	−865	−906

[1] The figures for 2008 are CBO's current estimates of budget authority and outlays for FHA's multifamily programs, the HECM program, and GNMA's MBS program under Public Law 110–92. CBO annualizes the budget authority provided under continuing resolutions. The 2009–2012 amounts are CBO's baseline estimates of the net offsetting collections that would be generated by those programs, assuming that appropriation laws necessary to implement FHA and GNMA programs are enacted. Also included in the figure for 2008 is the estimated portion of the total credit subsidy appropriated for that year (i.e., $1 million) that will be used by FHA for the manufactured housing loan guarantee program.

Note.—GNMA = Government National Mortgage Association; HECM = Home Equity Conversion Mortgage; MBS = Mortgage-Backed Securities; FHA = Federal Housing Administration; * = costs or savings of less than $500,000.

Amendments to the HECM loan insurance program

HECM loans are considered to be "reverse mortgages" because they enable homeowners who are at least 62 years of age to withdraw some of the equity in their homes in the form of monthly payments, in a lump sum, or through a line of credit. Loan size is tied to loan limits that vary by geographic region, and such loans cannot be used to purchase another home. In addition, the origination fee charged by lenders is calculated as a percentage of the home's value.

FHA is permitted to guarantee up to a cumulative total of 275,000 loans; that number of loans was reached during 2007. The current continuing resolution (Public Law 110–92) eliminates the limit on the number of HECM loans FHA can insure through November 16, 2007. Consistent with CBO's standard convention of extrapolating a continuing resolution through the remainder of the fiscal year, this estimate is based on the assumption that there will be no limit on the number of HECM loans guaranteed in fiscal year

2008. In the absence of this bill, CBO assumes that the HECM program will be inactive beginning in 2009.

Enacting this legislation would permanently remove the statutory limitation on the number of loans that could be guaranteed, set a single nationwide limit on the dollar amount of a HECM loan that would be tied to the conforming loan amount, limit the origination fee to 1.5 percent of the home's value (subject to a minimum allowable amount), and allow borrowers to use HECM loans to purchase a new home. (Conforming loans have terms and conditions that follow the guidelines set forth by the government-sponsored enterprises (GSEs); the conforming loan amount is currently $417,000.)

Implementation of the HECM program, like all of FHA's mortgage insurance programs, is contingent on the enactment of appropriation laws that provide annual loan commitment authority. Thus, the estimated budgetary impact of this bill is considered to be discretionary, and it is tied to the demand for HECM loans and the estimated subsidy cost of the loan guarantees. Because, under credit reform procedures, guarantees of HECM loans are estimated to have negative subsidies (that is, they earn money for the government), CBO estimates that implementing those amendments would increase offsetting collections by about $1.7 billion over the 2008–2012 period.

Demand for HECM Loans. According to the National Reverse Mortgage Lenders Association (NRMLA) and other industry experts, the HECM program has risen in popularity in recent years. As more consumers are becoming aware of the product, more households are becoming eligible for the program (currently over 17 million households have owners who are age 65 or older, according to census data), and more seniors view the product as an alternative approach to financing home-improvement projects, medical costs, and other needs. In addition, sources in the mortgage industry have observed an increasing demand among seniors for new housing within senior communities. The number of HECM loans insured by FHA quadrupled from 2003 to 2006 (18,000 loans were insured in 2003, compared with 76,000 loans in 2006). Furthermore, based on the number of HECM loans insured as of mid-September 2007, that volume could reach 105,000 after final loan volume for 2007 is tallied by FHA.

Based on information from FHA, NRMLA, and other industry experts, CBO estimates that setting a single nationwide loan limit and permitting borrowers to use HECM loans to purchase a new home would result in a product that would be more attractive to borrowers and more easily marketed by lenders, resulting in some increased demand for HECM loans. On the other hand, the limit on the origination fee could result in a program that is less profitable for certain lenders, causing some to end or limit their participation in the program. A lower origination fee, however, could increase the program's attractiveness to some borrowers, assuming lenders do not increase interest rates significantly to compensate for lower origination fees. CBO anticipates that the bill would result in a higher volume of HECM loans than would occur under the provisions of the continuing resolution, thus increasing offsetting collections by $10 million in 2008.

Currently, the market for FHA's HECM loans appears to be very robust, and under this bill, FHA would probably insure more than 110,000 loans annually beginning in 2009. Also, GNMA's recent decision to begin securitizing HECM loans could result in increased activity by lenders, as investors in the secondary mortgage market begin to invest in mortgage-backed securities that include this product. Whether the number of guarantees could exceed 110,000 loans on a continuing basis each year would depend on FHA's ability to administer and manage the program in an efficient manner and on the market's response to this bill. Based on information from FHA, CBO estimates that the agency could insure about 112,000 loans (with a face value of about $28 billion) in 2009. In subsequent years, we estimate that demand would increase at the estimated rates of appreciation in housing prices—about 2 percent to 4 percent a year.

Subsidy Cost. Under current law, FHA guarantees of HECM loans are estimated to result in net offsetting collections to the federal government because guarantee fees for those mortgages are currently estimated to more than offset the costs of expected defaults. For 2008, the Department of Housing and Urban Development's (HUD's) subsidy estimate for HECM loan guarantees is −1.9 percent. Under the expanded program authorized by this legislation, CBO estimates that the subsidy rate for the HECM loans would be −1.35 percent. This reduction from the estimated rate for 2008 is due to the increased risk FHA would experience under the proposed nationwide loan limitation. With larger loan sizes, the "equity cushion" (that is the difference between the home's value and the potential cost of a claim payment) would decrease, leading to potentially more costly claims for FHA. CBO estimates that implementing this legislation would result in additional offsetting collections of $1.7 billion over the 2008–2012 period, contingent on enactment of appropriation bills that would establish the authority to make HECM loan guarantees by specifying annual loan commitment levels.

Additional GNMA offsetting collections from HECM provisions

GNMA is responsible for guaranteeing securities backed by pools of mortgages that are insured by the federal government. In exchange for a fee charged to lenders or issuers of the securities, GNMA guarantees the timely payments of scheduled principal and interest due on the pooled mortgages that back those securities. Because, under credit reform procedures, the value of the fees collected by GNMA is estimated to exceed the cost of loan defaults in each year, the Administration estimates that the GNMA MBS program will have a subsidy rate of −0.21 percent in 2008, resulting in the net collection of receipts to the federal government.

Currently GNMA does not securitize HECM loans; according to GNMA, however, securitization of those loans will begin sometime 2008. CBO estimates that in 2008 about 5 percent of the HECM loans will be included in GNMA's MBS program. (Only a small portion of this 5 percent would stem from the changes made to the HECM program in 2008 under this legislation.) We estimate that in subsequent years, 10 percent to 20 percent of the HECM loans would be securitized by GNMA. Thus, CBO estimates that the changes to the HECM loan program in this bill would result in additional offsetting collections to GNMA, totaling about $37 million over the 2008–2012 period, assuming appropriation action to establish a dollar limitation for the GNMA securities program.

Raising loan limits for the single-family program

Section 102 would raise FHA's loan limit—the dollar amount of a mortgage that FHA can insure—for its single-family program from 87 percent of the conforming loan amount to 100 percent of the conforming loan limit in certain geographic regions where the cost of housing is very high. Effectively, this would be a change from insuring loans of $362,790 today to insuring loans of up to $417,000 in certain parts of the country. In less expensive markets, the limit would be raised from 48 percent to 65 percent of the conforming loan limit, or an increase in the ceiling from $200,160 to $271,050 under the bill.

CBO estimates that implementing this provision would increase loan volume by about 8 percent a year—about $4 billion annually in additional loan guarantees—over the next five years. This increase would stem mostly from increasing the limit in the less expensive housing markets. Despite this estimated increase in loan volume, CBO estimates that no additional offsetting collections would be realized because we expect the subsidy rate for the single-family program to be zero over the next five years. However, because most FRA single-family loan guarantees are included in GNMA's MBS program, CBO estimates that raising the loan limit would result in additional offsetting collections to GNMA of about $45 million over the 2008–2012 period. (Because GNMA requires appropriation action to establish its dollar limitation for the securities program, those savings would be offsets to discretionary spending.)

Limit on premium increases for mortgage insurance

Currently, FHA has the authority to adjust fees for its mortgage insurance programs through administrative action. Section 120 would prohibit FHA from increasing fees through 2009 unless the increase is required to maintain the estimated credit subsidy for the program at zero, but not less than zero. Based on information from the Administration, CBO expects that annual fees for new loan guarantees for the apartment development and refinance programs will increase by about 16 basis points beginning in early 2008. The weighted average subsidy rate for those programs is currently about −2 percent. CBO estimates that those fee increases would affect about $2.6 billion in loan guarantees in 2008 and more than $3 billion in loan guarantees annually in subsequent years. Furthermore, we estimate that those fee increases would increase offsetting collections for this program by $63 million over the 2008–2009 period. Thus, prohibiting those fee increases would result in a loss—relative to the current-law baseline—of $63 million in discretionary offsetting collections over the 2008–2009 period.

Improving FHA's administrative functions

Section 116 would authorize the appropriation of $25 million annually over the 2008–2012 period. Such funding would be used to improve FHA's technologies, processes, and overall program performance associated with the execution of its mortgage insurance programs. CBO estimates that implementing this section would cost $119 million over the 2008–2012 period. Those funds would not be authorized to be appropriated each year unless HUD, by rule, determines that FHA premiums being charged that year are sufficient to comply with the Mutual Mortgage Insurance Fund's (MMIF's) capital ratio requirement and are also sufficient to ensure the safety and soundness of other FHA mortgage insurance funds.

In addition, section 118 would require HUD to establish a three-year demonstration program to test the effectiveness of various forms of pre-purchasing financial counseling. HUD already provides several types of housing counseling services, and CBO expects that implementing the pilot program would result in no significant additional costs to the federal government. However, this section also would allow (but not require) HUD to reduce mortgage insurance premiums for certain borrowers who agree to participate in a counseling program. Such fee reductions could increase the subsidy rate for the affected loan guarantees. (The Federal Credit Reform Act of 1990 requires the appropriation of funds to cover subsidy costs of loan guarantees.) The cost of this provision would depend on the degree of any fee reduction provided and other risk factors associated with those borrowers, which have not been determined by FHA. CBO estimates that such costs would probably not be significant, given that only 3,000 borrowers could participate in the demonstration program.

Amendments to the Manufactured Housing Insurance program

Guarantees of manufactured housing loans fall under title I of the National Housing Act. Under that act, FHA has authority to insure home improvement loans. The volume of manufactured housing loans guaranteed by FHA has fallen from 30,000 per year in the 1990s to fewer than 2,000 loans per year in recent years. Furthermore, in the late 1990s GNMA experienced significant losses from its securitization of those manufactured housing loans. As a result of those losses, GNMA imposed a moratorium on new issues of securities for those loans.

Moreover, financing options for manufactured housing are very limited. Currently, only two private lenders participate in the FHA program, and because no private secondary market exists, most private lenders and insurers have no incentive to make loans or loan guarantees for manufactured housing. Despite the fact that there are relatively few financing options available for manufactured housing, there are about 11 million manufactured homes in the United States (mostly in rural areas), according to the Manufactured Housing Institute (MHI). Most of those manufactured houses are financed through personal loans. Title II of this legislation would make several amendments designed to increase demand for FHA's manufactured housing loan program.

Proposed Changes. Under current law, FHA limits its exposure to losses from manufactured housing loan guarantees by capping the lender's insurance coverage at 10 percent of the value of the lender's portfolio for the title I program. That is, FHA pays only lender claims that total no more than 10 percent of the value of the lender's loan portfolio for the title I loans. As a result, the amount of insurance that FHA provides for each loan varies. Enacting this legislation would eliminate this insurance structure for loans associated with manufactured homes and would direct FHA to insure 90 percent of each individual loan. That change would significantly expand the government's liability under the program.

Title II of this legislation also would raise the loan limit for insuring a manufactured home by about 40 percent and would require that the limit be indexed for inflation on an annual basis. According to FHA, the average cost of a manufactured home is about $60,000. Current law limits FHA to guaranteeing the purchase of manufactured homes to $48,000; under the legislation, this limit would increase to $69,678 after the program changes are implemented in 2009.

Currently, borrowers are charged a 1 percent up-front fee for a manufactured home loan guarantee. Because the fees collected are not expected to exceed the cost of defaults, FHA estimates that the manufactured housing loan guarantee program has a subsidy rate of about 1 percent. Enacting this legislation would require FHA to assess higher premiums to offset the cost of expected defaults to yield an estimated negative credit subsidy rate for the program. Based on information from FHA, CBO expects that FHA would set the up-front premium for borrowers at about 2.25 percent and the annual premium at 1 percent. CBO expects that those fees would be sufficient to make the program's estimated subsidy rate close to zero, assuming that the pattern of future default rates in this program is similar to recent history—about 9.5 percent. Because there is essentially no private market for manufactured housing loan guarantees to compare to the federal program, it is uncertain whether those higher fees would result in a program with no net cost. On balance, CBO estimates that implementing the manufactured housing provisions would result in net costs or savings of less than $500,000 a year beginning in fiscal year 2009.

Cost of Program. Based on information from FHA and MHI, CBO estimates that it would take about one year to implement the changes proposed under the bill. Furthermore, CBO anticipates that significant outreach by FHA would be needed to identify and educate prospective borrowers and lenders about the manufactured housing program reforms. Thus, CBO estimates that the number of loans insured under the program would begin to grow by about 5 percent annually beginning in 2009. Assuming this gradual increase in demand and an estimated subsidy rate for 2009 and subsequent years that is near zero, CBO estimates that implementing this legislation would result in a net cost or savings of less than $500,000 a year over the 2009–2012 period.

GNMA Savings. According to GNMA, the agency would consider securitizing additional manufactured housing loans following an evaluation of the program after the proposed changes are implemented and to the extent FHA has begun to guarantee a significant number of loans, most likely with a face value close to at least $1 billion. Because CBO estimates that it would take FHA many years to increase its business volume to that level, we estimate that the manufactured housing provisions would not generate any additional offsetting collections associated with GNMA's MBS program over the next five years.

Fees and downpayment requirements

Currently, FHA's single-family loan guarantee program has a flat premium structure under which all borrowers pay the same up-front and annual fees, regardless of the borrower's individual risk of default. Based on information from FHA, CBO expects that, in 2008, the up-front fee will increase from 1.5 percent to 1.66 percent and the annual fee will rise from 0.5 percent to 0.55 percent. (The maximum fees allowable under current law are 2.25 percent for the up-front fee and 0.55 percent for the annual fee.) HUD estimates that those fee increases will result in a subsidy rate of zero for the single-family program for 2008.

Under this legislation, FHA would have the authority to raise the up-front premium to 3 percent and to offer guarantees for loans with downpayments as low as 1.5 percent of the principal loan amount. Because the subsidy rate for 2008 is estimated to be zero under current law, CBO expects that FHA, with these new authorities, would continue to charge fees under this bill that would produce a similar result.

Intergovernmental and private-sector impact: The legislation contains no intergovernmental or private-sector mandates as defined in UMRA and would impose no costs on state, local, or tribal governments.

Previous CBO estimates: On June 1, 2007, CBO transmitted a cost estimate for H.R. 2139, the FHA Manufactured Housing Loan Modernization Act of 2007, as ordered reported by the House Committee on Financial Services on May 23, 2007. H.R. 2139 and title II of this legislation would make the same changes to the manufactured housing insurance program; thus, the costs associated with this program are identical in the two estimates.

On June 11, CBO transmitted a cost estimate for H.R. 1852, the Expanding American Homeownership Act of 2007, as ordered reported by the House Committee on Financial Services on May 3, 2007. Both H.R. 1852 and this legislation contain nearly identical provisions affecting the HECM program, the loan limits for FHA's single-family program, and FHA's administrative functions. The costs associated with those provisions are estimated to be the same for the two bills beginning in 2009. In addition, both bills include provisions limiting fee increases for certain FHA loan guarantees, though the provision in H.R. 1852 would make the limitation permanent while the provision in this legislation would extend the limitation only through 2009. This difference is reflected in the cost estimates.

Other differences exist between the two bills, and those differences are also reflected in the cost estimates.

On September 12, 2007, CBO transmitted a cost estimate for H.R. 2895, the National Affordable Housing Trust Fund, as ordered reported by the House Committee on Financial Services on July 31, 2007. Similar to H.R. 1852, H.R. 2895 includes a provision to permanently limit fee increases for certain FHA loan guarantees.

Estimate prepared by: Federal Costs: Susanne S. Mehlman; Impact on State, Local, and Tribal Governments: Elizabeth Cove; Impact on the Private Sector: Paige Piper/Bach.

Estimate approved by: Peter H. Fontaine, Assistant Director for Budget Analysis.

ADDITIONAL VIEWS OF SENATORS SHELBY, ALLARD, DOLE, CRAPO, SUNUNU, ENZI, BENNETT AND BUNNING

The FHA only insures the lender's credit loss, not the borrower's ability to remain in their home. Therefore, efforts to extend the scope of the FHA should balance providing additional opportunities for home ownership with the risk of loss to the American taxpayer.

One of the precursors to increasing defaults in the subprime market was the introduction of subprime mortgage products requiring little, or even no, equity on the part of the borrower. The recent pattern of delinquencies and defaults in the subprime market clearly illustrates that those borrowers with little or no equity in their home will be the most likely to find themselves in a serious financial predicament. The FHA's own reporting states, "* * * a borrower's equity position in the mortgaged house is one of the most important drivers of default behavior. The larger the equity position a borrower has, the greater the incentive to avoid default on the loan." (FHA MMI Fund Analysis FY2006). With declining home prices predicted by almost all economic forecasters, borrowers starting with little or no equity today could quickly discover that their home is worth less than they owe. Consequently, a family's greatest asset could become its greatest liability in very short order. Because equity gives borrowers a stake in their home and a cushion against falling home values, this Committee rightly rejected calls to allow FHA to insure zero-down payment loans. It chose, instead, to require FHA borrowers to continue to provide a down payment of at least 1.5%. We believe this is the absolute minimum that should be required especially in light of continuing distress in the residential real estate market. Therefore, we urge the Secretary to monitor closely market conditions and consider seriously requiring higher down payments when appropriate.

Although this bill reduces the minimum down payment to 1.5%, it does retain current law which directs the HUD Secretary to require borrowers with a loan to value in excess of 97 percent to complete a counseling program. The Secretary does have the authority to waive the counseling requirement. For approximately fifteen years, however, the Secretary has done neither. Such inaction fails to meet both the legislative mandate of the National Housing Act and the minimum requirements of the Administrative Procedures Act. The HUD Secretary should comply with the law and require all new borrowers with less than 3 percent equity in their homes to complete a counseling program. Doing so would help borrowers enter home ownership in a more informed and responsible manner.

The reported bill also directs HUD to improve its loss mitigation procedures. The purpose of loss mitigation is not simply to allow a defaulted borrower to stay in their home, but to also make the mortgage sustainable. HUD's Inspector General (IG) has reported several failings with the FHA's current loss mitigation procedures.

For instance, the FHA has pushed servicers to approve borrowers for loss mitigation even when a workout is unlikely to succeed. According to HUD's IG, "These actions are delaying the foreclosure process, increasing the cost of foreclosure, and subsidizing borrowers who don't pay their mortgage for extended periods of time." HUD's IG also reported that, "some borrowers are withholding mortgage payments to qualify for assistance." The FHA should not, in its loss mitigation process, reward borrowers who choose to game or cheat the system. Foreclosure assistance should only be available to those who show a willingness to pay their mortgage because delinquent borrowers who attempt to game the FHA's loss mitigation process undermine the financial soundness of the FHA and the integrity of the process. Therefore, as suggested by HUD's IG, the FHA should "(1) ensure that good business judgment is followed when determining whether the borrower qualities for the program, (2) reduce the time frames for processing loss mitigation, and (3) require borrowers to make a good faith effort of making three normal payments before completing a partial claim."

The FHA's current and future financial condition pose great concern. While the FHA currently has significant capital on hand, current capital holdings are irrelevant if future liabilities swamp future assets. According to the Office of Management and Budget, in the absence of programmatic or premium changes, the FHA's total costs exceed its receipts on a present value basis. Further, the FHA's portfolio is experiencing delinquency rates comparable to that in the subprime market. Therefore, any attempt to simply shift the riskiest borrowers from the subprime market into FHA insured loans will increase the likelihood that losses in the subprime market will be borne by taxpayers instead of investors. Such a shift will also continue to encourage families into home ownership that is not sustainable. If the FHA is allowed to assume these greater risks, this Committee must exercise considerable and extensive oversight to insure the financial soundness of the Mutual Mortgage Insurance fund and reduce any potential liability to the American taxpayer.

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